Supreme Court, U.S.
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No. _____

IN THE

Supreme Court of the United States

MORGAN STANLEY DEAN WITTER & CO.,

Petitioner,

v.

JAMES ROSKIND,

Respondent.

On Petition For A Writ Of Certiorari To The California Court Of Appeal

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

A comprehensive federal scheme governs the manner in which securities broker-dealers execute customer trade orders. The question presented, on which the highest courts of several States are in conflict, is whether state-law claims that seek to impose different trading standards on broker-dealers are preempted by federal law.

INTERESTED PARTIES

All parties to the proceeding below are listed in the caption. Respondent purports to bring this action on behalf of a class of persons similarly situated, although no class was certified below. Petitioner, a publicly traded company, has no parent company. The following companies are nonwholly owned subsidiaries of petitioner as of November 1, 2000: Morgan Stanley Capital International Inc.; Morgan Stanley Dean Witter Investment Management Private Limited; Morgan Stanley India Securities Limited; JM Morgan Stanley Securities Limited; AB Asesores Bursátiles Cordoba, S.A.; AB Asesores Bursátiles Murcia, S.A.; AB Asesores Bursátiles Sur, S.A.; AB Asesores Ceuta, S.L.; AB Asesores Castilla, S.A.; AB Asesores CFMB Almeria, S.A.; Providence Cayman Investments Limited; Alfa Romeo Vertriebsgesellschaft mbH; and Viale Marconi Immobiliare S.à.r.l.

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On Petition For A Writ Of Certiorari To The California Court Of Appeal

PETITION FOR A WRIT OF CERTIORARI

Petitioner Morgan Stanley Dean Witter & Co. ("Morgan Stanley") respectfully petitions this Court for a writ of certiorari to review a decision of the California Court of Appeal.

OPINIONS BELOW

The opinion of the California Court of Appeal (App., *infra*, 1a-15a) is reported at 80 Cal. App. 4th 345. The order of the California Supreme Court denying Morgan Stanley's petition for review (App., *infra*, 16a) is not reported.

JURISDICTION

The California Supreme Court denied Morgan Stanley's petition for discretionary review on August 16, 2000. App., *infra*, 16a. The jurisdiction of this Court is invoked under 28 U.S.C. § 1257. The California Court of Appeal's determination that the state-law claims in

this case are not preempted by federal law is "final" for purposes of this Court's certiorari jurisdiction. *See, e.g., Goodyear Atomic Corp.* v. *Miller*, 486 U.S. 174, 178-80 (1988); *Belknap, Inc.* v. *Hale*, 463 U.S. 491, 497 n.5 (1983).

CONSTITUTIONAL PROVISION AND RULES INVOLVED

The Supremacy Clause (U.S. Const., Art. VI, § 2) provides in pertinent part that "[t]his Constitution, and the Laws of the United States which shall be made in Pursuance thereof . . . shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding."

The National Association of Securities Dealers' "best execution" rule (Conduct Rule 2320) is reproduced in the Appendix, *infra*, at 17a-19a. Its "trading ahead" rule (Conduct Rule Interpretation IM-2110-2) is reproduced in the Appendix, *infra*, at 20a-24a.

STATEMENT OF THE CASE

Respondent James Roskind sued his broker, Morgan Stanley, alleging that the manner in which Morgan Stanley executed a securities trade violated California law. App., *infra*, 3a. Respondent charged that Morgan Stanley failed to immediately execute his sell order and sold the same securities from its own account before executing respondent's order. Respondent thus alleged, under state law, that Morgan Stanley had violated its obligations to obtain "best execution" of his order and to avoid "trading ahead" of that order—two broker-dealer practices that are subject to comprehensive federal regulations, which differ in material respects from respon-

dent's state-law allegations. The state Superior Court sustained Morgan Stanley's demurrer on the ground that respondent's claims were preempted by federal law. *Id.* at 4a. The Court of Appeal reversed. *Id.* at 4a-15a. The California Supreme Court denied discretionary review. *Id.* at 16a.

I. The Federal Regulatory Scheme

The National Association of Securities Dealers ("NASD") regulates the conduct of securities broker-dealers such as Morgan Stanley pursuant to a comprehensive federal regulatory scheme supervised by the Securities and Exchange Commission ("SEC"). *See Sparta Surgical Corp.* v. *NASD, Inc.*, 159 F.3d 1209, 1210 (9th Cir. 1998) (NASD "is the primary regulatory body for the broker-dealer industry"). The NASD, with the SEC's express approval, has adopted rules governing broker-dealer trading practices, *including the particular practices challenged by respondent*, and those rules—which have the force of federal law (*see id.* at 1211-13)—are enforced by the NASD and the SEC through disciplinary procedures.

A. The National Market System

The Securities Exchange Act of 1934, 15 U.S.C. §§ 78a *et seq.* (the "Exchange Act"), is the primary federal statute governing the conduct of broker-dealers and the securities markets. Pursuant to the Exchange Act, the SEC "oversees the equity markets and participants," while "[m]ost of the day-to-day responsibility for market and broker-dealer oversight is performed by self-regulatory organizations ('SROs')," such as the NASD. SEC Division of Market Regulation, *Market 2000: An Examination of Current Equity Market Developments*

(1994), at VI-1 ("*Market 2000 Report*"); *see also Merrill Lynch, Pierce, Fenner & Smith, Inc.* v. *NASD, Inc.*, 616 F.2d 1363, 1368 (5th Cir. 1980) ("the NASD plays an important role in a complex self-regulatory scheme carefully set down by Congress").

The Exchange Act was amended in 1975 to enable the SEC "to use its authority . . . to facilitate the establishment of a national market system for securities." 15 U.S.C. § 78k-1(a)(2); *see also* S. Rep. No. 75, 94th Cong., 1st Sess. 8 (1975) (1975 amendments intended to "clarify and enhance the authority of the SEC to take all necessary steps to bring such a national market system into existence"). Congress authorized the SEC to work with and supervise the SROs, including the NASD, in the creation and maintenance of such a system. *See* 15 U.S.C. § 78k-1(a)(3)(B). Under this regulatory regime, "[t]he NASD exercises quasi-governmental authority pursuant to a statutory scheme enacted by the national sovereign." *Austin Municipal Securities, Inc.* v. *NASD, Inc.*, 757 F.2d 676, 692 (5th Cir. 1985); *see also United States* v. *NASD, Inc.*, 422 U.S. 694, 732 (1975) ("The SEC's supervisory authority over the NASD is extensive").

B. SRO Rulemaking Authority

The NASD exercises its regulatory authority through rulemaking and interpretive guidance. In making and interpreting rules governing participants in the securities markets, the NASD must strike a delicate balance. Congress has directed the NASD to enact rules to protect the investing public. 15 U.S.C. § 78o-3(b)(6). At the same time, "[t]he rules of the association [must] not impose any burden on competition not necessary or appropriate

in furtherance of the purposes of this title." 15 U.S.C. § 78o-3(b)(9).

With limited exceptions not applicable here, the NASD must file proposed rules with the SEC, and no rule may take effect until the SEC approves it. *See* 15 U.S.C. § 78s(b). The SEC must ensure that the "rules of the association are designed to . . . remove impediments to and perfect the mechanism of a free and open market and a national market system." 15 U.S.C. § 78o-3(b)(6). The SEC's approval of an NASD rule constitutes a determination by the SEC that the rule comports with congressional directives. *See Shearson/American Express Inc.* v. *McMahon*, 482 U.S. 220, 233 (1987) ("No proposed rule change may take effect unless the SEC finds that the proposed rule is consistent with the requirements of the Exchange Act"). Moreover, the SEC "may abrogate, add to, and delete from" the NASD's rules. 15 U.S.C. § 78s(c).

The NASD has adopted, with the SEC's express approval, rules concerning the "best execution" of trades and the practice of "trading ahead"—the very issues that form the basis of respondent's complaint. *See* C.A. App. 9 (alleging that Morgan Stanley "failed to obtain the quickest and best execution of trade orders" and "traded ahead of such trade orders").

1. NASD's "Best Execution" Rule

It is undisputed that "[g]enerally, a broker-dealer has a duty to seek to obtain best execution for customer orders, which is understood to mean that a broker-dealer must obtain the most favorable terms available under the circumstances for a customer's transaction." *Market 2000 Report* at V-1. But, while the general duty of best

execution is well-established, the SEC "has *not* promulgated a separate best execution rule or explicitly defined best execution. Rather, how the broker-dealer satisfies its duty continues to evolve with changes in technology and market structure." SEC Report, *On-Line Brokerage: Keeping Apace of Cyberspace* (Nov. 22, 1999), at 35 (emphasis added).

In the absence of SEC rulemaking in this area, the SROs "have prescribed rules or provided interpretive guidance concerning their members' duty to obtain the best execution of customer orders." *Market 2000 Report* at V-2. The NASD's "best execution" rule provides that a broker-dealer must use "reasonable diligence" in executing customer orders in light of prevailing market conditions. NASD Conduct Rule 2320(a), *reprinted in NASD Manual* (CCH), at 4265. The NASD has also adopted a multi-factor test to apply in ascertaining whether a broker-dealer has used "reasonable diligence" in executing a trade. *See ibid.* This non-exclusive list of factors allows the NASD to apply its specialized expertise in making the highly fact-specific determination whether, in light of the particular circumstances presented, a broker-dealer has fulfilled its obligation to obtain the best execution of trade orders.

2. NASD's "Trading Ahead" Rule

The NASD, with the SEC's express approval, has also regulated the practice of "trading ahead" for more than a decade: *See In re E.F. Hutton & Co.*, SEC Release No. 25887 (July 6, 1988). The NASD's current limitation on trading ahead provides that a broker-dealer holding a marketable customer limit order must execute that order before trading in the same security for its own account. NASD Conduct Rule Interpretation IM-2110-

2, *reprinted in NASD Manual* at 4122. This rule interpretation was expressly approved by the SEC as being consistent with the Exchange Act. *See* SEC Release No. 35751 (May 22, 1995); NASD *Special Notice to Members* 95-43 (June 5, 1995).

C. SRO Disciplinary Authority

The Exchange Act requires the NASD to conduct regular examinations, investigations and disciplinary proceedings as necessary to ensure compliance with securities laws, rules, and regulations, and directs the NASD to ensure that broker-dealers are "appropriately disciplined" for any violations. 15 U.S.C. § 78o-3(b)(7); *see also* 15 U.S.C. § 78o-3(b)(8) (NASD must provide a "fair procedure for the disciplining of members"). The NASD's rules and disciplinary system are designed to fulfill its congressional mandate "to insure fair dealing and to protect investors from harmful or unfair trading practices." *Merrill Lynch, Pierce, Fenner & Smith, Inc.* v. *Ware*, 414 U.S. 117, 130 (1973). The SEC reviews NASD disciplinary proceedings to ensure adequate protection of both investors and competition, and the SEC's decisions can be appealed to federal court. *See NASD Manual* at 154; *Austin*, 757 F.2d at 680 ("The SEC closely scrutinizes the disciplinary process").

II. The Securities Transaction At Issue

Respondent owned stock in Netscape Communications Corporation, which was traded on the Nasdaq stock market. App., *infra*, 2a. The Nasdaq "is an interdealer quotation system," which "consists of competing market makers for each security." *Market 2000 Report* at II-11. "[M]arket makers [are] willing to buy and sell securities for their own account at their displayed bid

and ask price." *Id.* at V-5. Morgan Stanley made a market in Netscape stock. *See* C.A. App. 5

Before the market opened on February 8, 1996, respondent placed an order with Morgan Stanley to sell 14,000 shares of Netscape for at least $65 per share. *Id.* at 6. Morgan Stanley executed respondent's order 77 minutes after the market opened, selling respondent's Netscape stock for an average price of approximately $65.50 per share. *See* App., *infra*, 2a. Between the time the market opened and the time respondent's shares were sold, Morgan Stanley allegedly sold a block of shares of Netscape for its own account at a price of $66.00 per share. *Ibid.*

A. Proceedings Before The NASD

The NASD, which operates the Nasdaq market and is the principal regulator of broker-dealers such as Morgan Stanley, initiated an investigation into the manner in which Morgan Stanley handled the trade orders of respondent and two other customers. App., *infra*, 3a. Without admitting liability or conceding that it had violated the NASD's fair trading rules, including its prohibition on "trading ahead," Morgan Stanley entered into a negotiated settlement with the NASD pursuant to which it made full restitution (measured as the difference between the price at market open and the trade price) to respondent and the other two customers. *See ibid.*; *NASD Market Regulation Committee v. Morgan Stanley & Co.*, Decision and Order of Acceptance of Offer of Settlement (Feb. 4, 1998) (*reprinted at* C.A. App. 102-06). Respondent has thus received the full difference between the amount he actually realized and the amount he would have received if his order to sell all 14,000 shares had been executed at the price quoted when the

market opened, plus interest.[1] Respondent nonetheless alleges that Morgan Stanley "did not pay [him] the entire interest he claimed was also due on the amount of the loss." App., *infra*, 3a.

B. The State-Court Action

Respondent subsequently filed this lawsuit in the California Superior Court. *See* App., *infra*, 3a. He asserted two causes of action: In the first, he alleged that Morgan Stanley had violated California's Unfair Competition Law, which prohibits "unlawful, unfair, or fraudulent business practice[s]" (Cal. Bus. & Prof. Code § 17200), by "fail[ing] to obtain the quickest and *best execution* of trade orders by its California consumer customers and *trad[ing] ahead* of such trade orders by placing its own financial interest ahead of [respondent] and other California consumers." C.A. App. 9 (emphases added). In his second cause of action, purportedly brought on behalf of a class of all Morgan Stanley customers for a six-year period dating back to 1992, respondent alleged that the same conduct also constituted a breach of Morgan Stanley's fiduciary duties to its customers. *Id.* at 10.

Morgan Stanley sought to dismiss respondent's complaint on the ground, *inter alia*, that his claims that Morgan Stanley had failed to obtain the "best execution" of his transaction and had "traded ahead" of his order

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[1] Respondent received the difference between $68.00 per share (the price at market open) and $65.5244 per share (the average sale price) for his 14,000 shares, for a total of $34,658.40, plus interest of $3,344.34, for a total restitutionary award of $38,002.74. C.A. App. 106; *see id.* at 61-62.

were preempted by the comprehensive federal regulatory scheme that authoritatively governs the issues of best execution and trading ahead. C.A. App. 47, 69-74. At the hearing on the demurrer, the Superior Court expressed its concern that "if . . . we permit 50 different states to inject themselves into the regulation of securities and brokers," state-law actions such as this one might "ultimately interfer[e] inappropriately with the regular functioning of the market." *Id.* at 1080. Accordingly, the Superior Court sustained Morgan Stanley's demurrer on the ground that both causes of action were "preempted by federal securities laws, rules, and regulations." *Id.* at 1119.

The California Court of Appeal reversed in a published opinion. The court concluded that "any federal law remedy is merely a supplement to the state law remedies available, and federal law does not preempt the state law claims we review." App., *infra*, 9a. In particular, the court concluded that, notwithstanding the detailed and complex scheme of federal securities and broker-dealer regulation, respondent could maintain a cause of action under the California UCL based on his claims that Morgan Stanley had failed to obtain "best execution" of his trade order and had "traded ahead" of his order. *Id.* at 9a-15a; *see also id.* at 11a n.4. The court thus determined that state law may govern broker-dealers' obligations in connection with trading ahead and best execution notwithstanding, and contrary to, the NASD's carefully calibrated approach to these issues under the federal regulatory scheme.

REASONS FOR GRANTING THE PETITION

Review of the decision in this case is warranted for three reasons: *First*, it irreconcilably conflicts with decisions of other courts, including the highest courts of four States, regarding the preemptive effect of federal law in this area; *second*, it is fundamentally inconsistent with the law of federal preemption as articulated by this Court; and, *third*, it is simply wrong as a matter of federal law.

I. There Is A Conflict Of Authority As To The Preemptive Effect Of Federal Securities Regulations

The decision below cannot be reconciled with *Guice* v. *Charles Schwab & Co.*, 89 N.Y.2d 31 (1996), *cert. denied*, 520 U.S. 1118 (1997), and other state high court decisions addressing the preemptive effect of federal securities laws and regulations in circumstances analogous to those in this case. The courts in those cases, in sharp contrast to the court below, held that state-law challenges to broker-dealer trading practices were preempted by the federal scheme of securities regulation.

A. Numerous Courts Have Held State-Law Claims Preempted In Analogous Circumstances

In *Guice*, as in this case, the plaintiffs alleged that their respective brokers had failed to obtain the "best execution" of their trade orders, and that this failure violated state law. 89 N.Y.2d at 38. The particular practice challenged by the *Guice* plaintiffs was the brokers' receipt of "payments for order flow," or remuneration paid to retail broker-dealers for routing transactions to specified wholesale broker-dealers or market makers. *Id.* at

37. The New York Court of Appeals held that the *Guice* plaintiffs' state-law "best execution" claims were "pre-empted by the 1975 amendments to the Securities Exchange Act and implementing SEC regulations." *Id.* at 38-39.

The *Guice* court correctly recognized that "[i]mplied conflict preemption may be found when it is impossible for one to act in compliance with both the Federal and State laws, or when the state law . . . stan[ds] as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress." 89 N.Y.2d at 39 (citing *Barnett Bank of Marion County* v. *Nelson*, 517 U.S. 25, 31 (1996), and *Hines* v. *Davidowitz*, 312 U.S. 52, 67 (1941)) (internal quotations omitted). The court also recognized that federal regulations, as well as statutes, may conflict with—and therefore preempt—state law. *Ibid.* (citing *Capital Cities Cable, Inc.* v. *Crisp*, 467 U.S. 691, 699-700 (1984); *Fidelity Fed. Sav. & Loan Ass'n* v. *De la Cuesta*, 458 U.S. 141, 154 (1982)).

The court in *Guice* stressed that the 1975 amendments to the Exchange Act "were intended to give the SEC the power administratively to develop a coherent and rational regulatory structure to correspond to and to police effectively the new national market system," and, to that end, gave the SEC the quasi-legislative authority to promulgate rules ensuring "more economically efficient execution of securities transactions." 89 N.Y.2d at 46 (internal quotations omitted). Pursuant to that authority, the SEC had addressed the practice of payments for order flow, and had required only limited disclosure of such payments. *See id.* at 41-43.

Because the SEC had addressed the practice of payments for order flow pursuant to its statutory authority to

regulate the national market system, the New York Court of Appeals held that an additional layer of state regulation would interfere with the orderly operation of the federal regime:

> Permitting the courts of each State to impose civil liability on national securities brokerage firms, such as Schwab and Fidelity, for failure to meet more stringent common-law agency standards of disclosure of receipt of order flow payments (rather than the Federally mandated *uniform* specific disclosure . . .) would inevitably defeat the congressional purpose of enabling the SEC to develop and police that "coherent regulatory structure" for a national market system. Securities broker-dealers, confronted with the risk of nationwide class action civil damage liability, . . . would be impelled to tailor their disclosures to each State's common-law agency jurisprudence, and the carefully crafted SEC disclosure requirements would have little, if any, influence.

Guice, 89 N.Y.2d at 46-47. As the *Guice* court recognized, "'[i]t is unlikely—to say the least—that Congress intended to establish such a chaotic regulatory structure.'" *Id.* at 47 (quoting *International Paper Co.* v. *Ouellette*, 479 U.S. 481, 497 (1987)).

The *Guice* court held that state-law challenges to broker-dealer trading practices also "would thwart the objectives of Congress in a second respect." 89 N.Y.2d at 47. The SEC had considered, and rejected, proposals for more exacting disclosure of order flow payments by broker-dealers, evidencing a determination by the federal regulators that the practice was consistent with the

policies of the Exchange Act. The New York Court of Appeals recognized that the imposition of state-law liability would impose "deleterious if not ruinous effects" on this practice, notwithstanding the SEC's approval, which adverse effects the court held "are alone sufficient to require preemption." *Id.* at 48.

Numerous courts across the country, including the highest courts of Pennsylvania, Illinois and Minnesota, have reached the same conclusion, holding that state-law challenges to broker-dealer trading practices are preempted by the pervasive federal regulatory scheme to which broker-dealers are subject. *Shulick* v. *PaineWebber, Inc.*, 554 Pa. 524, 530 (1998) ("Clearly, by imposing requirements that vary from those established by the SEC, state requirements under the common law would diverge from federally imposed standards"); *Orman* v. *Charles Schwab & Co.*, 179 Ill. 2d 282, 294-97 (1997) ("Given the history and purpose of Congress' 1975 amendments to the Exchange Act as well as the SEC's implementing regulations vis-à-vis order flow payment disclosures, we are convinced that allowing plaintiffs' related state claims to advance would obstruct the National Market System that Congress intended to foster in enacting the 1975 Amendments"), *cert. denied*, 523 U.S. 1075 (1998); *Dahl* v. *Charles Schwab & Co.*, 545 N.W.2d 918, 925 (Minn.) ("the remedies [the plaintiffs] seek could frustrate the objectives of the SEC and Congress"), *cert. denied*, 519 U.S. 866 (1996); *see also Dumont* v. *Charles Schwab & Co.*, 717 So. 2d 1182, 1186-87 (La. App. 1998); *McKey* v. *Charles Schwab & Co.*, 67 Cal. App. 4th 731, 742 (1998); *Eirman* v. *Olde Discount Corp.*, 697 So. 2d 865, 865-66 (Fla. App. 1997).

B. The Decision Below Conflicts With The Weight Of Authority

As with the practice of payments for order flow, the SEC and NASD have adopted regulations regarding broker-dealers' best execution obligations and the practice of trading ahead. And, unlike respondent's state-law claims, the scheme of federal regulation with respect to these areas is also quite balanced and carefully calibrated. As in *Guice* and the other "best execution" cases, imposition of state law in these circumstances would disrupt the national market system.

The court below, however, dismissed this substantial body of authority on the ground that the California Supreme Court, in *Diamond Multimedia Systems, Inc.* v. *Superior Court*, 19 Cal. 4th 1036, 1057, *cert. denied*, 527 U.S. 1003 (1999), had "cited *but declined to follow* the line of out of state cases addressing the very different issue of 'order flow payments,' whose application is urged here by Morgan [Stanley]." App., *infra*, 9a (citing *Guice* and *Dahl*) (emphasis added). The Court of Appeal similarly "declined to follow" those cases, and thereby rendered a decision that conflicts with them.

The dissenting justice in *Diamond* had argued that *Guice* and its progeny indicated that an action under a state statute prohibiting certain forms of market manipulation (Cal. Bus. & Prof. Code § 25400) was preempted by federal law. *See* 19 Cal. 4th at 1068-69 (Brown, J., dissenting). The Supreme Court of California rejected that argument, concluding that, with one limited exception, "there is no preemption" of state law by the federal securities laws. *Ibid.*; *see also id.* at 1057 ("except to the extent it has been subsequently modified by the Securities Litigation Uniform Standards Act of 1998, fed-

eral law in this arena supplements, but does not displace state regulation and remedies").

Although the *Diamond* court was construing a state anti-fraud statute that paralleled federal securities law, rather than a trade practices statute that does not, the Court of Appeal in this case construed *Diamond* as dictating the holding that "*any* federal law remedy is merely a supplement to the state law remedies available, and federal law does not preempt the state claims we review." App., *infra*, 9a (citing *Diamond*, 19 Cal. 4th at 1057) (emphasis added). The court below also said that Morgan Stanley's argument that *Guice* and *Dahl* compelled a finding of preemption in this case had been "rejected by the majority in *Diamond*." *Id.* at 11a n.2.

The decision below is thus flatly inconsistent with the *Guice* line of cases. Those cases hold that state-law challenges to broker-dealer trading practices are preempted where the federal regulators have adopted rules regarding the practice, and the imposition of additional requirements would interfere with the national market system. These factors compel a finding of preemption in this case as well. The NASD and the SEC have regulated the best execution obligations of broker-dealers, including the practice of trading ahead, and the imposition of state-law liability in these circumstances would circumvent the carefully calibrated scheme adopted by the federal regulators.

The court below, in reliance on the California Supreme Court's similar refusal in *Diamond*, expressly refused to follow the *Guice* line of cases regarding the preemptive effect of federal securities regulation. *See also O'Malley* v. *Boris*, 742 A.2d 845, 849 (Del. 1999) (refusing to follow *Guice* in case alleging preemptive

effect of NASD rules). The courts of a significant number of States—including those (California, Delaware, Illinois, and New York) in which a great deal of corporate litigation is filed—have thus reached conflicting decisions regarding the proper scope of federal preemption. Although the California and Delaware courts are in the minority, this conflict of authority can only be expected to widen over time. Such uncertainty on this important and recurring issue should be addressed and resolved promptly by this Court.

II. The Decision Below Conflicts With This Court's Preemption Decisions

Not only does the decision below conflict with the numerous decisions holding that federal law preempts state-law challenges to broker-dealer trading practices, but the decision also cannot be reconciled with this Court's preemption jurisprudence. *See, e.g.*, *Crosby* v. *National Foreign Trade Council*, 120 S. Ct. 2288 (2000), and *Geier* v. *American Honda Motor Co.*, 120 S. Ct. 1913 (2000) (both decided after the Court of Appeal's decision in this case). In particular, the Court of Appeal ignored two fundamental principles of federal preemption: It failed to apply properly the doctrine of obstacle preemption, and it gave undue weight to the "saving clause" in the Exchange Act.

A. The Court Of Appeal Ignored The Doctrine Of Obstacle Preemption

State law is preempted if it "stands as an obstacle to the accomplishment and execution of the full purposes and objectives" of the federal regulatory system. *Capital Cities Cable*, 467 U.S. at 699 (internal quotation omitted). Just last Term, this Court reiterated that "[w]hat is a sufficient obstacle is a matter of judgment,

to be informed by examining the federal statute as a whole and identifying its purpose and intended effects." *Crosby*, 120 S. Ct. at 2294. The court below failed to undertake such an examination. Rather, it merely asserted, incorrectly, that "[a]pplication of state laws such as the UCL to forbid the practice of trading ahead would not impair or conflict with any provision of federal law." App., *infra*, 11a.

If respondent were successful on his claims for relief, broker-dealers such as Morgan Stanley would be forced to comply with state-law standards of trading that could differ materially from the best execution and trading ahead rules established by the federal regulators. This Court in *Crosby* found it pertinent to the preemption analysis that "the state statute penalizes some private action that the federal Act . . . may allow," and that the state law "conflicts with federal law at a number of points by penalizing individuals and conduct that Congress has explicitly exempted or excluded from sanctions." 120 S. Ct. at 2296-97; *see also id.* at 2297 ("the state Act's generality stands at odds with the federal discreteness"). So, too, here.

Respondent's state-law challenges would frustrate the congressional policy of a uniform *national* market system, and would conflict with the federal regulatory scheme. If he were to succeed on any of his claims, securities brokers would be forced to comply with the particularized—and, perhaps, broadly applicable—rule announced by a California state court, rather than with the quite different, and more balanced, rules promulgated by the federal regulatory authorities. *Cf. Crosby*, 120 S. Ct. at 2298 ("Sanctions are drawn not only to bar what they prohibit but to allow what they permit"). As a result,

this lawsuit would stand as an obstacle to the full implementation of the federal regulatory scheme, and therefore is preempted by federal law.

The Court of Appeal asserted that respondent's claims were not preempted because "[a]pplication of state laws such as the UCL to forbid the practice of trading ahead . . . would be *consistent with* the purposes and aims of federal law." App., *infra*, 11a (emphasis added). This Court rejected the identical argument just last Term: "The fact of a common end hardly neutralizes conflicting means, and the fact that some companies may be able to comply with both sets of sanctions does not mean that the state Act is not at odds with achievement of the federal decision about the right degree of pressure to employ." *Crosby*, 120 S. Ct. at 2297-98 (citation and footnote omitted).

The court below ignored this Court's admonition that "[i]n determining whether state law 'stands as an obstacle' to the full implementation of federal law *it is not enough to say that the ultimate goal of both federal and state law is the same*. A state law also is preempted if it interferes with the *methods* by which the federal statute was designed to reach [its] goal." *Gade* v. *National Solid Wastes Management Ass'n*, 505 U.S. 88, 103 (1992) (emphases added; internal quotation omitted); *see also Ouellette*, 479 U.S. at 494. Here, the *method* Congress employed to achieve its goal of a true *national* market system is the interlocking structure of federal-level rulemaking and enforcement by the SROs, subject to oversight by the SEC, which balances the goals of investor protection and market competition.

Allowing respondent's claims to proceed would frustrate that federal purpose by overriding the SEC-

approved distinctions carefully made by the NASD in regulating best execution and trading ahead. As the *Guice* court explained in analogous circumstances, "although both State common-law actions and Federal regulations may promote broker-dealers' disclosure to customers, State enforcement of agency law standards of disclosure cannot help but upset the policy-based delicate balance Congress directed the SEC to achieve in the regulatory regime envisaged under the 1975 amendments to the Securities Exchange Act." 89 N.Y.2d at 48-49.

This Court reaffirmed the doctrine of obstacle preemption just last Term, holding that a state-law tort suit alleging that automobile manufacturers had a duty to install airbags in their vehicles conflicted with federal regulations that "deliberately sought variety—a mix of several different passive restraint systems." *Geier*, 120 S. Ct. at 1924. As the Court explained:

> In effect, petitioners' tort action depends upon its claim that manufacturers had a duty to install an airbag when they manufactured the 1987 Honda Accord. Such a state law—*i.e.*, a rule of state tort law imposing such a duty—by its terms would have required manufacturers of all similar cars to install airbags rather than other passive restraint systems, such as automatic belts or passive interiors. *It thereby would have presented an obstacle to the variety and mix of devices that the federal regulation sought.*

Id. at 1925 (emphasis added). The reasoning employed by the *Geier* Court applies with equal force to respondent's claims. The blanket proscription on trading ahead and the rigid obligation to obtain the best price regard-

less of other circumstances that respondent seeks are inconsistent with the flexible rules adopted by the NASD and the SEC in these areas. *See* Part III, *infra*.

B. The Court Of Appeal Misconstrued The Exchange Act's Saving Clause

In addition to the pervasive scheme of federal regulation, many States, including California, regulate various aspects of the securities industry. In some circumstances, such state regulation—which frequently parallels the federal regime—is not preempted by federal law. That is because the Exchange Act contains a "saving clause" that preserves certain state-law remedies. 15 U.S.C. § 78bb(a). As this Court has explained, "Congress plainly contemplated the possibility of dual litigation in state and federal courts relating to securities transactions." *Matsushita Electric Industrial Co.* v. *Epstein*, 516 U.S. 367, 383 (1996).

The Court of Appeal construed the Exchange Act's saving clause as "disclos[ing] a Congressional intent to leave state laws in place, and not preempted." App., *infra*, 15a (citing *Diamond*, 19 Cal. 4th at 1057 n.17).[2] This Court's recent *Geier* decision points up the error in the Court of Appeal's decision. In that case, the applicable federal statute contained a saving clause providing

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[2] In so doing, the Court of Appeal expressly refused to follow a prior unpublished decision of the Ninth Circuit, which the court below recognized constituted "contrary authority supporting Morgan's claims." *See* App., *infra*, 13a (citing *Shearson Lehman Brothers Inc.* v. *Greenberg*, 1995 U.S. App. LEXIS 17313 (9th Cir. 1995) (holding that state-law claims were preempted by federal securities laws)).

that compliance with federal regulations did not exempt automobile manufacturers from liability under common law. The Court held that, while this provision meant that not *all* state-law actions would be preempted, "the saving clause . . . does *not* bar the ordinary working of conflict pre-emption principles." 120 S. Ct. at 1919. That is because the Court "has repeatedly declined to give broad effect to saving clauses where doing so would upset the careful regulatory scheme established by federal law." *Ibid.* (internal quotation omitted).

As this Court has explained, "Congress intended to subject the exchanges to state regulation that is *not inconsistent* with the federal Act." *Merrill Lynch*, 414 U.S. at 137 (emphasis added). Thus, like the saving clause in *Geier*, the Exchange Act's saving clause, 15 U.S.C. § 78bb(a), does not foreclose the possibility of implied preemption. *See, e.g.*, *Guice*, 89 N.Y.2d at 49; *McKey*, 67 Cal. App. 4th at 737. Contrary to the Court of Appeal's overly broad interpretation, therefore, the Exchange Act's saving clause cannot be read to mean that state-law actions involving securities transactions are *never* preempted. On the contrary, where—as here—the state law would stand as an obstacle to the implementation of the national market system, the preemptive effect of federal law must be enforced.

III. The Decision Below Is Wrong

Respondent alleged that, under state law, Morgan Stanley was obliged (1) to secure the "best price" for his trade order, (2) not to act as a principal and agent in the same transaction, and (3) not to trade ahead of respondent's alleged market order. *See* C.A. App. 4-5. Even if respondent had accurately characterized the facts surrounding this transaction, each of his assertions regard-

ing Morgan Stanley's legal obligations would be inconsistent with the detailed and balanced requirements of the comprehensive federal regulatory scheme.[3]

First, in alleging that Morgan Stanley failed to obtain the best execution of his trades, respondent contended that he did not receive the "best price" because some of the trades allegedly were made "outside the bid/ask range" (*i.e.*, below the "best bid" quoted on the Nasdaq computerized market system). C.A. App. 7; *see also id.* at 2. This allegation is squarely at odds with the federal regulators' interpretation of the best execution obligation. *See, e.g., In re Merrill Lynch*, 911 F. Supp. 754, 770 (D.N.J. 1995) ("Brokers have *not* been held . . . to an absolute requirement of achieving the most favorable price on each order") (emphasis added), *overruled on other grounds*, 135 F.3d 266 (3d Cir. 1998); *Market 2000 Report* at V-2 ("a broker-dealer is not bound exclusively by price considerations in satisfying best execution obligations").

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[3] The expansion of liability under state law proposed by respondent would also deprive Morgan Stanley and other broker-dealers of the important procedural protections secured by federal law, including the right to have any disciplinary sanctions reviewed by the SEC. The removal of such federal benefits is an additional obstacle to the implementation of the federal scheme. *See Bibbo* v. *Dean Witter Reynolds, Inc.*, 151 F.3d 559, 564 (6th Cir. 1998); *Levitin* v. *PaineWebber, Inc.*, 159 F.3d 698, 706 (2d Cir. 1998), *cert. denied*, 525 U.S. 1144 (1999). The court below dismissed these authorities (with which its decision also conflicts) on the ground that "[t]he instant case concerns solely California law, not preemptive or conflicting federal law." App., *infra*, 12a n.5 (citing *Diamond*, 19 Cal. 4th at 1057).

Rather than focusing only on price, as respondent's state-law claims do, the NASD has stressed that "the application of best execution concepts necessarily involves a 'facts and circumstances' analysis." NASD *Notice to Members* 97-57 (July 1995). Indeed, "[d]epending on the particular set of facts surrounding an execution, *actions that in one set of circumstances may meet a firm's best execution obligation, may not meet that standard in another set of circumstances*." *Ibid.* (emphasis added). Thus, the NASD has authoritatively determined that, as a matter of federal securities law, a broker-dealer's best execution obligations cannot be determined in the abstract; rather, they must be evaluated on a case-by-case basis. Respondent's best execution claims, which he asserts not only on his own behalf but also on behalf of *all* California brokerage customers, are inconsistent with the case-specific inquiry that the NASD has mandated because recognizing those claims would require imposing an unprecedented uniform "best price" obligation on the broker-dealer industry.

The SEC agrees that best execution cannot be reduced to a simple formula. Factors considered by the SEC in this regard "include, among other things, the size of the order, the trading characteristics of the security involved, the availability of accurate information affecting choices as to the most favorable market in which execution might be sought, the availability of technological aids to process such data, the availability of economic access to the various market centers and the cost and difficulty associated with achieving an execution in a particular market center." *Market 2000 Report* at V-3 (quoting H.R. Rep. No. 145, 95th Cong., 1st Sess. 233 (1977)).

As SEC Chairman Arthur Levitt has explained, "[b]est execution encompasses a number of factors starting with the price of the execution and the opportunity for price improvement. Other factors include speed and likelihood of execution." SEC Release No. 99-146 (Nov. 4, 1999). Respondent's claims, which focus *solely* on the price at which a trade was executed, fail to take into account these other factors and thus conflict with the SEC's carefully developed approach. Moreover, according to Chairman Levitt, "[n]ow is not the time for rulemaking regarding order executions. We must not enter the millennium handcuffed by potentially cumbersome, and perhaps even soon outdated restrictions." *Ibid.* If an SEC rule on this subject would "handcuff" the national market system, allowing state courts to regulate best execution in accordance with individual standards devised by judges and juries would operate as an impediment to the very market evolution that the federal regulators have sought to encourage.

Second, respondent's assertion that Morgan Stanley should not purchase for its own account (as principal) securities sold by it for its customers (as agent) cannot be reconciled with the SEC's approach to this issue. As the federal regulators have explained, "the Commission does not believe that a broker-dealer violates its best execution obligation merely because it . . . trades as principal with customer orders." NASD *Notice to Members* 96-65 (Oct. 1996), at 541 (quoting SEC Release No. 37619A (Sept. 12, 1996)). Indeed, prohibiting NASD members acting as market makers from buying or selling for their own accounts while executing customer orders would destroy a fundamental aspect of the Nasdaq stock market.

Third, respondent's approach to trading ahead contains none of the balances that are built into the detailed federal regulatory structure. As noted above, the SEC-approved NASD rules generally prohibit brokers from trading ahead of customer orders. That prohibition, however, is subject to several limitations: First, it applies only to unexecuted *limit* orders (*i.e.*, orders in which the customer directs the broker to purchase or sell a security at no more or less than a particular price), and does not preclude trading ahead of customer *market* orders (*i.e.*, those in which the broker is directed to buy or sell a security at the market price). Second, even with respect to limit orders, the NASD's prohibition on trading ahead does not apply to limit orders that are marketable when received by the broker (*i.e.*, can be executed at the limit price in the prevailing market). *See NASD Manual* at 4123. Third, the NASD's limitation on trading ahead applies only "from 9:30 a.m. to 6:30 p.m. Eastern Time" (*id.* at 4121), and thus does not apply to after-hours trading.

Respondent, by contrast, sweepingly asserts that "Morgan Stanley was obliged . . . not to become a principal in a transaction until after it has completed *whatever* agency orders it has on hand (*i.e.* not 'trading ahead' of its clients)." C.A. App. 5 (emphasis added). Respondent thus asserts that Morgan Stanley should not have traded ahead of his alleged *market* order, notwithstanding the fact that such a practice is not prohibited under the NASD's trading ahead interpretation. *See NASD Manual* at 4123. And, if respondent's order is ultimately determined to be a limit order, his theory would prohibit trading ahead of such an order even though the NASD has already concluded that such an

action would be proper.[4] The blanket proscription on trading ahead sought by respondent would override the carefully balanced rules promulgated by the NASD, and would eviscerate the finely wrought federal regulatory scheme.

In short, the Court of Appeal's express conclusion that a state court can "forbid" trading ahead in all circumstances (*see* App., *infra*, 11a), as well as its implicit conclusion that a state court can apply a standard of best execution that differs from that imposed by federal regulation, cannot be reconciled with the comprehensive and detailed federal regulatory regime applicable to broker-dealers such as Morgan Stanley.

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[4] The NASD made clear in the order approving the settlement that there was a fundamental factual dispute over whether respondent's order was a market order or a limit order. If it was a limit order, the NASD observed that the manner in which Morgan Stanley executed the order "would have been proper." C.A. App. 105. Indeed, because the Morgan Stanley trader who executed the order believed it was a limit order, the NASD dismissed all charges against him. *Id.* at 105-06.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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November 14, 2000

APPENDIX

CERTIFIED FOR PUBLICATION

IN THE COURT OF APPEAL OF THE STATE OF CALIFORNIA

FIRST APPELLATE DISTRICT

DIVISION FIVE

A087546

(San Francisco County Super. Ct. No. 997731)

JAMES ROSKIND, Plaintiff and Appellant,

v.

MORGAN STANLEY DEAN WITTER & CO., Defendant and Respondent.

Filed April 27, 2000
Modified May 26, 2000

STEVENS, J.—Does federal law preempt a state law cause of action brought under California's unfair competition law (UCL), Business and Professions Code section 17200 et seq.,[1] where a brokerage firm is alleged to have violated its duty to its customers, by not executing their

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[1] Unless otherwise indicated, all further section references are to the Business and Professions Code.

orders for stock sales in a fair and timely manner, and by instead "trading ahead" for its own benefit before processing those sales for its customers? We conclude there is no provision of federal law that preempts a state law cause of action under the UCL in these circumstances, and therefore we must reverse the judgment of the trial court.

I. FACTS AND PROCEDURAL HISTORY

As this appeal proceeds from a judgment following a ruling sustaining a demurrer without leave to amend, we must accept the facts as properly pleaded by appellant James Roskind.

Appellant alleged that he owned a large block of stock in Netscape, which was listed on the NASDAQ (National Association of Securities Dealers Automated Quotation System) exchange. Appellant instructed his stockbroker, Morgan Stanley Dean Witter & Co. (Morgan), to sell 14,000 shares of Netscape stock on his behalf. Instead of selling appellant's stock in a timely fashion, for the $68 per share at which the stock was then trading, Morgan delayed the sale of appellant's stock for a crucial 77 minutes, during which time the value of Netscape stock dropped to $65.50 per share. During this delay period, Morgan "traded ahead" by selling its own large block of Netscape stock first, at $66 per share, then sold appellant's stock at prices between $65.25 and $65.75 per share. Some of the sales of Netscape stock that Morgan executed for appellant were at a price that was so low that it was outside the "bid/ask range" established for Netscape at the time of those sales. As a result of Morgan's delay and its trading ahead, appellant lost more than $34,000 which he would

otherwise have gained if his stock had been sold in a timely fashion.

Appellant complained about Morgan's behavior in trading ahead in Netscape stock, first to Morgan, and then to the Market Regulation Committee of the National Association of Securities Dealers, Inc. (NASD), a private self-regulating group of dealers on the NASDAQ exchange. NASD investigated the matter, and Morgan decided to accept a settlement of charges brought by the NASD. The settlement between NASD and Morgan resulted in the censure of Morgan by NASD, the imposition of a fine of $35,000, and the repayment to appellant of more than $34,000. Morgan also made repayment to two other affected customers. However, Morgan did not pay appellant the entire interest he claimed was also due on the amount of the loss. Nor was Morgan ordered to repay any other customers, other than appellant and the two customers named in the NASD settlement.

Appellant then brought this class action lawsuit, seeking restitution and injunctive relief for himself and all other similarly situated customers of Morgan who had lost money as a result of Morgan's practice of trading ahead. His complaint states two causes of action arising under California state law. The first cause of action, brought under the UCL, alleges that the practice of trading ahead is an unfair and unlawful business practice under the UCL. The second cause of action alleges a breach of fiduciary duty by Morgan in trading ahead of its clients.

Morgan sought to remove the lawsuit from state court to the federal district court for the Northern District of California. However, the federal court found that the complaint did not raise a claim within the federal

court's jurisdiction, and therefore was not properly removable. The federal court then remanded the action to state court.

When the matter returned to state court on remand, Morgan filed a demurrer, contending that federal law preempted appellant's claims. The trial court ultimately sustained the demurrer without leave to amend on the grounds of federal preemption. This appeal followed.

II. DISCUSSION

A. Standard of Review

"For purposes of ruling on a demurrer, the court assumes the truth of all well-pleaded allegations of a complaint. The ability of the plaintiff to prove them is not in issue." (*Diamond Multimedia Systems, Inc. v. Superior Court* (1999) 19 Cal. 4th 1036, 1041, fn. 4 (*Diamond*).) Instead, the facts alleged must be treated as having been admitted, and we review de novo to determine whether the facts as pleaded could entitle the plaintiff to any legal remedy as a matter of law. (*Quelimane Co. v. Stewart Title Guaranty Co.* (1998) 19 Cal. 4th 26, 38 (*Quelimane*).)

A demurrer merely tests the legal sufficiency of the complaint, not its factual truth. (*Hernandez v. City of Pomona* (1996) 49 Cal. App. 4th 1492, 1497.) On appeal, "[w]e give the complaint a reasonable interpretation, reading it as a whole and viewing its parts in context. [Citations.] We deem to be true all material facts properly pled. [Citation.]" (*Lazar v. Hertz Corp.* (1999) 69 Cal. App. 4th 1494, 1501.) "In other words, 'plaintiff need only plead facts showing that he may be entitled to some relief [citation].' (*Alcorn v. Anbro Engineering, Inc.* (1970) 2 Cal. 3d 493, 496.)" (*Gruenberg v. Aetna*

Ins. Co. (1973) 9 Cal. 3d 566, 572 (*Gruenberg*); accord, *Quelimane, supra*, 19 Cal. 4th at p. 38; *Moore v. Regents of University of California* (1990) 51 Cal. 3d 120, 125.)

Despite these uniform authorities holding that we are presented with a pure question of law which we must review de novo, Morgan argues that we should review only for an abuse of discretion. We reject this argument. The cases cited by Morgan for this result do not support its position as to a demurrer, and, in the review of a judgment following trial, deal instead with the very different issue of whether a court in a UCL action may grant equitable relief, such as an injunction. (See *Cel-Tech Communications, Inc. v. Los Angeles Cellular Telephone Co.* (1999) 20 Cal. 4th 163, 179 (*Cel-Tech*) [UCL remedies are generally limited to civil penalties, restitution and injunctive relief]; *Olsen v. Breeze, Inc.* (1996) 48 Cal. App. 4th 608, 620 [no abuse of discretion where court declined to grant injunctive relief, because claim of unenforceability of contract was without merit]; *California Grocers Assn. v. Bank of America* (1994) 22 Cal. App. 4th 205, 215-218 [trial court abused its discretion by granting injunctive relief, because claims of unconscionability were without merit].)

In the instant case, we do not review an order granting or denying injunctive relief following trial. Instead, we review a judgment entered after the sustaining of a demurrer without leave to amend, which presents the question of whether "'"it appears that the plaintiff is entitled to any relief at the hands of the court against the defendants."'" This presents "a pure question of law." (*CAMSI IV v. Hunter Technology Corp.* (1991) 230 Cal. App. 3d 1525, 1530, quoting *Gruenberg, supra*, 9 Cal.

3d at p. 572.) We construe the allegations of the complaint liberally "'with a view to substantial justice between the parties.'" (230 Cal. App. 3d at p. 1530, citing, inter alia, Code Civ. Proc., § 452.)

B. The UCL Cause of Action was not Preempted by Federal Law

1. Background on the UCL

Appellant's first cause of action rests on section 17200, the main substantive provision of the UCL. The remedies available under this law are "cumulative . . . to the remedies or penalties available under all other laws of this state." (§ 17205.) The UCL "does not proscribe specific practices. Rather, as relevant here, it defines 'unfair competition' to include 'any unlawful, unfair or fraudulent business act or practice.' (§ 17200.) Its coverage is 'sweeping, embracing "'anything that can properly be called a business practice and that at the same time is forbidden by law.'"' (*Rubin v. Green* (1993) 4 Cal. 4th 1187, 1200, quoting *Barquis v. Merchants Collection Assn.* (1972) 7 Cal. 3d 94, 113.) . . . By proscribing 'any unlawful' business practice, 'section 17200 "borrows" violations of other laws and treats them as unlawful practices' that the unfair competition law makes independently actionable. (*State Farm Fire & Casualty Co. v. Superior* Court (1996) 45 Cal. App. 4th 1093, 1103, citing *Farmers Ins. Exchange v. Superior Court* [1992] 2 Cal. 4th [377,] 383.)" (*Cel-Tech, supra*, 20 Cal. 4th at p. 180, fn. omitted.)

"However, the law does more than just borrow. The statutory language referring to 'any unlawful, unfair *or* fraudulent' practice (italics added) makes clear that a practice may be deemed unfair even if not specifically

proscribed by some other law. 'Because Business and Professions Code section 17200 is written in the disjunctive, it establishes three varieties of unfair competition—acts or practices which are unlawful, or unfair, or fraudulent. "In other words, a practice is prohibited as 'unfair' or 'deceptive' even if not 'unlawful' and vice versa."' (*Podolsky v. First Healthcare Corp.* (1996) 50 Cal. App. 4th 632, 647, quoting *State Farm Fire & Casualty Co. v. Superior Court*, *supra*, 45 Cal. App. 4th at p. 1102.)" (*Cel-Tech*, *supra*, 20 Cal. 4th at p. 180.)

"'[T]he Legislature . . . intended by this sweeping language to permit tribunals to enjoin on-going wrongful business conduct in whatever context such activity might occur. Indeed, . . . the section was intentionally framed in its broad, sweeping language, precisely to enable judicial tribunals to deal with the innumerable "'new schemes which the fertility of man's invention would contrive.'" (*American Philatelic Soc. v. Claibourne* (1935) 3 Cal. 2d 689, 698 [*Claibourne*].) As the *Claibourne* court observed: "When a scheme is evolved which on its face violates the fundamental rules of honesty and fair dealing, a court of equity is not impotent to frustrate its consummation because the scheme is an original one. . . ." (3 Cal. 2d at pp. 698-699 . . . ; accord, *FTC v. The Sperry & Hutchinson Co.* (1972) 405 U.S. 233, 240.) With respect to "unlawful" or "unfair" business practices, [former] section 3369 [today section 17200] specifically grants our courts that power. [¶] In permitting the restraining of all "unfair" business practices, [former] section 3369 [today section 17200] undeniably establishes only a wide standard to guide courts of equity; as noted above, given the creative nature of the scheming mind, the Legislature evidently concluded

that a less inclusive standard would not be adequate.' (*Barquis v. Merchants Collection Assn.*, *supra*, 7 Cal. 3d at pp. 111-112, fn. omitted.) '[I]t would be impossible to draft in advance detailed plans and specifications of all acts and conduct to be prohibited [citations], since unfair or fraudulent business practices may run the gamut of human ingenuity and chicanery.' (*People* ex rel. *Mosk v. National Research Co. of Cal.* [1962] 201 Cal. App. 2d [765,] 772.)" (*Cel-Tech*, *supra*, 20 Cal. 4th at p. 181.) Under these broad and sweeping precedents, it is clear that the UCL could potentially provide a remedy for the conduct in issue here, if the UCL is not preempted by federal law in this context. (See *Diamond*, *supra*, 19 Cal. 4th at pp. 1046-1047.)

2. Federal Law Supplements, but Does Not Preempt State Law in this Area.

Congress contemplated that federal law would generally only supplement, not replace, state laws which would otherwise apply in this area of securities regulation. As our Supreme Court recently observed when turning aside a challenge to the application of California's state securities laws to interstate securities sales: "The contention that state exercise of jurisdiction over interstate transactions would somehow be inconsistent with federal law and thus violate the supremacy clause (U.S. Const., art. VI, cl. 2) also lacks merit. [¶] The Securities Exchange Act of 1934 (15 U.S.C. § 78bb(a)) makes it clear that, except to the extent it has been subsequently modified by the Securities Litigation Uniform Standards Act of 1998, federal law in this arena supplements, but does not displace state regulation and remedies." (*Diamond*, *supra*, 19 Cal. 4th at pp. 1056-1057.) "Congress plainly contemplated the possibility of dual

litigation in state and federal courts relating to securities transactions." (*Matsushita Elec. Industrial Co. v. Epstein* (1996) 516 U.S. 367, 383; *Merrill Lynch, Pierce, Fenner & Smith v. Ware* (1973) 414 U.S. 117, 137-140 [statutory remedies available under California state law were not preempted by rules of the New York Stock Exchange or congressional enactments].)

Consistent with this analysis, case authority clearly provides that violation of a federal law may serve as a predicate for a section 17200 action. (*State Farm Fire & Casualty Co. v. Superior Court*, *supra*, 45 Cal. App. 4th at pp. 1102-1103; *Citizens For a Better Envir. v. Union Oil of Cal.* (N.D. Cal. 1997) 996 F. Supp. 934.)

Guided by this case law and legal background, we conclude federal law does not preempt the state law claims in issue here. Rather, as our Supreme Court in *Diamond* held, "federal law in this arena supplements, but does not displace state regulation and remedies." Thus, any federal law remedy is merely a supplement to the state law remedies available, and federal law does not preempt the state law claims we review. (*Diamond*, *supra*, 19 Cal. 4th at p. 1057.)

This result becomes even more clear, when we consider that our Supreme Court in *Diamond* cited but declined to follow the line of out of state cases addressing the very different issue of "order flow payments," whose application is urged here by Morgan. (*Guice v. Charles Schwab & Co., Inc.* (1996) 89 N.Y.2d 31 (*Guice*); *Dahl v. Charles Schwab & Co., Inc.* (Minn. 1996) 545 N.W.2d 918 (*Dahl*). *Guice* and *Dahl* held that the application of state laws would be preempted to the extent state law would otherwise apply to bar "order flow payments" or incentive payments to brokers who placed

their customers' orders through a particular wholesaler or market maker in stocks. Preemption however was based upon the fact that the Securities and Exchange Commission (SEC) had specifically decided not to outlaw, and had in fact effectively legalized, these "order flow payments" as long as the payments were disclosed to customers.

Although Justice Brown in her dissent in *Diamond* sought to read *Guice* and *Dahl* more broadly, in the manner Morgan urges us to do, and as indicating that state laws were preempted as to all subjects relating to the sales of securities, the majority in *Diamond* rejected her analysis: "Notwithstanding the effort of Justice Brown to draw analogies between this action and the issues in *Guice* [citation] and *Dahl* [citation], neither those cases nor the others on which Justice Brown relies holds that federal law preempts actions by shareholders for damages suffered as a result of market manipulation." (*Diamond*, *supra*, 19 Cal. 4th at p. 1047, fn. 12.)[2]

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[2] *Guice* and *Dahl* were followed by the Second District in *McKey v. Charles Schwab & Co.* (1998) 67 Cal. App. 4th 731, 737-739 (*McKey*), a case which also involved order flow payments, and which preceded *Diamond*. *McKey* was among "the others [cases] on which Justice Brown relie[d]" in her dissent in *Diamond*, and which our Supreme Court declined to follow outside the context of order flow payments. (*Diamond*, *supra*, 19 Cal. 4th at p. 1047, fn. 12 (maj. opn.); and p. 1068 (dis. opn. of Brown, J.).) We are bound by the decision of the majority in *Diamond*. (See *Auto Equity Sales, Inc. v. Superior Court* (1962) 57 Cal. 2d 450, 455 (*Auto Equity*).) In addition, although Morgan has cited numerous unpublished and out of state authorities, it has not cited or sought to distinguish *Diamond*, a decision which is binding on us.

[Footnote continued on next page]

In contrast to the issue of "order flow payments," where the SEC has legalized the practice in question as a matter of federal law, there is no SEC rule, NASD rule, or other federal law or regulation allowing the very different practice of trading ahead, which is in issue here. In fact, the practice of trading ahead is not permitted by federal civil or criminal law. In the context of criminal prosecutions, the federal courts have held that trading ahead by a broker constitutes the crimes of mail fraud and wire fraud under federal law, since it violates a broker's fiduciary duty to his customers. (*United States v. Dial* (7th Cir. 1985), 757 F.2d 163, 168-169, cert. den. (1985) 474 U.S. 838 (*Dial*).)[3]

We do not accept Morgan's assertions that Congress or other federal lawmakers intended to legalize the practice of trading ahead and make it the basis of a uniform federal system allowing violations of federal criminal law by securities brokers, and preempting the application of state laws to this unlawful practice. Application of state laws such as the UCL to forbid the practice of trading ahead would not impair or conflict with any provision of federal law, but would be consistent with the purposes and aims of federal law.[4] (See *Washington Mutual Bank v. Superior Court* (1999) 75 Cal. App. 4th

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Nor has Morgan acknowledged that its arguments based on *Guice* and *Dahl* were rejected by the majority in *Diamond*.

3 Morgan has not cited or distinguished *Dial*.

4 Appellant's state law claim for breach of fiduciary duty is also not preempted, for the same reasons. In fact, such a violation of fiduciary duty establishes one basis for both the federal mail fraud violation and the UCL violation.

773, 787 [permitting UCL action to proceed, because it was consistent with, and helped to implement the goals of, federal law].)[5] In fact, since trading ahead constitutes the crime of mail fraud under federal law, it is actionable under the UCL, which borrows other law, including federal law, to define the "unlawful" practices that are UCL violations. (See *Cel-Tech*, *supra*, 20 Cal. 4th at pp. 180-181; cf. also *Stop Youth Addiction, Inc. v. Lucky Stores, Inc.* (1998) 17 Cal. 4th 553, 562-573 [no preemption of UCL claims relating to tobacco sales to minors].)[6]

We also find instructive the case of *Fenning v. Glenfed, Inc.* (1995) 40 Cal. App. 4th 1285, 1290-1299 (*Fenning*). This state appeals court decision held that the UCL was not preempted by federal law, as to claims that a broker and bank violated the UCL by unfairly soliciting depositors of a bank to invest in unsafe securities.

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[5] We therefore find irrelevant the numerous other out of state or unpublished cases cited by Morgan, holding that a state law is preempted if it expressly conflicts with federal law. (See, e.g., *Levitin v. PaineWebber, Inc.* (2d Cir. 1998) 159 F.3d 698, 705-706 [state law regulating interest payments on margin transactions by brokers held preempted, because state law conflicted with federal laws on the same subject].) The instant case concerns solely California law, not preemptive or conflicting federal law. (See *Diamond*, *supra*, 19 Cal. 4th at p. 1057.)

[6] Appellant suggests that we should take judicial notice of his client agreement with Morgan, which provides for the application of state law to contractual disputes between the parties. "While judicial notice is permissible under Evidence Code sections 452 and 459, we deny the request." (*Diamond*, *supra*, 19 Cal. 4th at pp. 1058-1059, fn. 19.) We do not find the parties' contractual agreement relevant to the legal issue before us, federal preemption.

(See also *Newman v. First California Co.* (1975) 47 Cal. App. 3d 60, 65-68 [applying California law to claims that NASD-regulated broker did not properly and timely execute a customer's stock trade, and concluding that a defense "did not exist" based upon an asserted application of NASD regulations or laws other than California law]; *Hobbs v. Bateman Eichler, Hill Richards, Inc.* (1985) 164 Cal. App. 3d 174, 201-204 [allowing a state law claim for breach of fiduciary duty against a broker where the SEC had not acted regarding a particular broker practice].)

The only contrary authority supporting Morgan's claims of sweeping federal preemption is apparent dictum contained in an unpublished decision of the Ninth Circuit Court of Appeals, which that court has specified as not citable authority (see U.S. Cir. Ct. Rules (9th Cir.), rule 36-3), and which we also find unpersuasive here. (*Shearson Lehman Bros. v. Greenberg* (9th Cir., July 3, 1995, 93-55535) 1995 LEXIS 17313.) In this unpublished decision[7], which did not address recent California case law or the precise issue before us, a panel of the Ninth Circuit upheld the dismissal on summary judgment of a pro per plaintiff's claims brought

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[7] We note in this respect the existence of a problem that is beyond our powers to resolve. The Ninth Circuit rule concerning the citation of unpublished opinions of that court, rule 36-3, bars the citation of its unpublished cases in federal court, but not in state court. Our own rule of court on this topic, rule 977 of the California Rules of Court, does not explicitly speak to this problem. We suggest that our Supreme Court may wish to address this apparent oversight in rule 977, by considering the adoption of an amendment that is consistent with the Ninth Circuit rule as to such unpublished cases.

against his broker, based on other types of alleged violations of the UCL. The Ninth Circuit concluded the federal court had removal jurisdiction, contrary to the ruling of the federal court in the instant case; the UCL did not apply; and the appellant lacked standing. The court then added, in an apparent dictum or semble, "In fact, it seems likely that § 17200 is preempted entirely by federal securities laws. See 15 U.S.C. § 78bb."

The federal statute cited by the Ninth Circuit in aid of its statement, 15 United States Code Section 78bb, is the same statute cited by our Supreme Court in *Diamond* as supporting its holding that state laws are *not* preempted by federal securities laws. (*Diamond*, *supra*, 19 Cal. 4th at p. 1057, fn. 17.) We take note that 15 United States Code Section 78bb provides, in pertinent part, "[t]he rights and remedies provided by this chapter *shall be in addition to* any and all other rights and remedies that may exist in law or in equity . . . ." (Italics added.)

The decisions of the Ninth Circuit Court of Appeals cited by Morgan are not binding on us.[8] We view the

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[8] Morgan also cites us to a published Ninth Circuit decision, *Spinner Corp. v. Princeville Development Corp.* (9th Cir. 1988) 849 F.2d 388 (*Spinner*), which was decided under Hawaii law. *Spinner* held that the Hawaii "baby FTC Act" which was similar in many ways to the UCL, was inapplicable to securities law violations, because the Hawaii Legislature in passing the law had so indicated. The California UCL, by contrast, has always been given a broad and sweeping ambit by our Legislature and our Supreme Court. (*Cel-Tech*, *supra*, 20 Cal. 4th at p. 181; *Diamond*, *supra*, 19 Cal. 4th at p. 1047, fn. 12.) The UCL contains no language supporting an exclusion for securities, and under the plain language of the UCL, we cannot create such an exclusion. (*Ibid.*) In addition, we are bound (as would be the Ninth Circuit, on this is-

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dicta contained in its unpublished decisions, which may not be cited to the federal courts in the Ninth Circuit, as particularly unpersuasive authority. In construing 15 United States Code Section 78bb, we also agree with and are bound by the majority of our own Supreme Court in *Diamond* that the phrase "in addition to" discloses a Congressional intent to leave state laws in place, and not preempted. (*Diamond*, *supra*, 19 Cal. 4th at p. 1057, fn. 17; *Auto Equity*, *supra*, 57 Cal. 2d at p. 455.)[9]

III. DISPOSITION

The judgment is reversed. The matter is remanded to the trial court with instructions to overrule the demurrer.

STEVENS, J.

JONES, P.J. and KRAMER, J.* concurred.

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sue of state law) by our own Supreme Court's broad interpretation of California's UCL. (See *Auto Equity*, *supra*, 57 Cal. 2d at p. 455.)

9 Morgan also attempts to raise several miscellaneous issues which relate primarily to class certification. Because a motion to certify the class is yet to be brought and ruled upon, such contentions are premature. We decline the suggestion that we should issue an advisory opinion on matters that were not the subject of the lower court's ruling.

* Judge of the San Francisco Superior Court assigned by the Chief Justice pursuant to article VI, section 6 of the California Constitution.

Court of Appeal, First Appellate District, Division Five—No. A087546

S089019

IN THE SUPREME COURT OF CALIFORNIA
En Banc

JAMES ROSKIND, Appellant,

v.

MORGAN STANLEY DEAN WITTER & COMPANY, Respondent.

Filed August 16, 2000

Petition for review DENIED.

Brown, J., is of the opinion the petition should be granted.

The request for an order directing depublication of the opinion is denied.

GEORGE, C.J.

Selected NASD Conduct Rules

2320. Best Execution and Interpositioning

(a) In any transaction for or with a customer, a member and persons associated with a member shall use reasonable diligence to ascertain the best inter-dealer market for the subject security and buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions. Among the factors that will be considered in determining whether a member has used "reasonable diligence" are:

(1) The character of the market for the security, e.g., price, volatility, relative liquidity, and pressure on available communications;

(2) the size and type of transaction;

(3) the number of primary markets checked;

(4) location and accessibility to the customer's broker/dealer of primary markets and quotations sources.

(b) In any transaction for or with a customer, no member or person associated with a member shall interject a third party between the member and the best available market except in cases where the member can demonstrate that to his knowledge at the time of the transaction the total cost or proceeds of the transaction, as confirmed to the member acting for or with the customer, was better than the prevailing inter-dealer market for the security. A member's obligations to his customer are generally not fulfilled when he channels transactions through another broker/dealer or some person in

a similar position, unless he can show that by so doing he reduced the costs of the transactions to the customer.

(c) When a member cannot execute directly with a market maker but must employ a broker's broker or some other means in order to insure an execution advantageous to the customer, the burden of showing the acceptable circumstances for doing so is on the retail firm. Examples of acceptable circumstances are where a customer's order is "crossed" with another retail firm which has a corresponding order on the other side, or where the identity of the retail firm, if known, would likely cause undue price movements adversely affecting the cost or proceeds to the customer.

(d) Failure to maintain or adequately staff an over-the-counter order room or other department assigned to execute customers' orders cannot be considered justification for executing away from the best available market; nor can channeling orders through a third party as described above as reciprocation for service or business operate to relieve a member of his obligations. However, the channeling of customers' orders through a broker's broker or third party pursuant to established correspondent relationships under which executions are confirmed directly to the member acting as agent for the customer, such as where the third party gives up the name of the retail firm, are not prohibited if the cost of such service is not borne by the customer.

(e) A member through whom a retail order is channeled, as described above, and who knowingly is a party to an arrangement whereby the initiating member has not fulfilled his obligations under this Rule, will also be deemed to have violated this Rule.

(f) The obligations described in paragraphs (a) through (e) above exist not only where the member acts as agent for the account of his customer but also where retail transactions are executed as principal and contemporaneously offset. Such obligations do not relate to the reasonableness of commission rates, markups or markdowns which are governed by Rule 2440 and IM-2440.

(g)(1) In any transaction for or with a customer pertaining to the execution of an order in a non-Nasdaq security (as defined in the Rule 6700 Series), a member or person associated with a member, shall contact and obtain quotations from three dealers (or all dealers if three or less) to determine the best inter-dealer market for the subject security.

(2) Pursuant to the Rule 9600 Series, the staff, for good cause shown, after taking into consideration all relevant factors, may exempt any transaction or classes of transactions, either unconditionally or on specified terms, from any or all of the provisions of this paragraph if it determines that such exemption is consistent with the purpose of this Rule, the protection of investors, and the public interest.

IM-2110-2. Trading Ahead of Customer Limit Order

(a) General Applications

To continue to ensure investor protection and enhance market quality, the Association's Board of Governors is issuing an interpretation to the Rules of the Association dealing with member firms' treatment of their customer limit orders in Nasdaq securities. This interpretation, which is applicable from 9:30 a.m. to 6:30 p.m. Eastern Time, will require members acting as market makers to handle their customer limit orders with all due care so that market makers do not "trade ahead" of those limit orders. Thus, members acting as market makers that handle customer limit orders, whether received from their own customers or from another member, are prohibited from trading at prices equal or superior to that of the limit order without executing the limit order. Such orders shall be protected from executions at prices that are superior but not equal to that of the limit order. In the interests of investor protection, the Association is eliminating the so-called disclosure "safe harbor" previously established for members that fully disclosed to their customers the practice of trading ahead of a customer limit order by a market-making firm.*

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* For purposes of the pilot program expanding the operation of certain Nasdaq transaction and quotation reporting systems and facilities in SR-NASD-99-57 during the period from 4 p.m. to 6:30 p.m. Eastern Time, members may generally limit the life of a customer limit order to the period of 9:30 a.m. to 4 p.m. Eastern Time. If a customer does not formally assent ("opt-in") to processing of their limit order(s) during the extended hours period commencing after the normal close of the Nasdaq market, limit order protection will not apply to that customer's order(s).

Rule 2110 of the Association's Rules states that:

> A member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade.

Rule 2320, the Best Execution Rule, states that:

> In any transaction for or with a customer, a member and persons associated with a member shall use reasonable diligence to ascertain the best inter-dealer market for the subject security and buy or sell in such a market so that the resultant price to the customer is as favorable as possible to the customer under prevailing market conditions.

Interpretation

The following interpretation of Rule 2110 has been approved by the Board:

> A member firm that accepts and holds an unexecuted limit order from its customer (whether its own customer or a customer of another member) in a Nasdaq security and that continues to trade the subject security for its own market-making account at prices that would satisfy the customer's limit order, without executing that limit order, shall be deemed to have acted in a manner inconsistent with just and equitable principles of trade, in violation of Rule 2110, provided that, until September 1, 1995, customer limit orders in excess of 1,000 shares received from another member firm shall be protected from the market maker's executions at prices that are superior but not equal to that of

> the limit order, and provided further, that a member firm may negotiate specific terms and conditions applicable to the acceptance of limit orders only with respect to limit orders that are: (a) for customer accounts that meet the definition of an "institutional account" as that term is defined in Rule 3110(c)(4); or (b) 10,000 shares or more, unless such orders are less than $100,000 in value. Nothing in this interpretation, however, requires members to accept limit orders from any customer.

By rescinding the safe harbor position and adopting this interpretation, the Association wishes to emphasize that members may not trade ahead of their customer limit orders in their market-making capacity even if the member had in the past fully disclosed the practice to its customers prior to accepting limit orders. The Association believes that, pursuant to Rule 2110, members accepting and holding unexecuted customer limit orders owe certain duties to their customers and the customers of other member firms that may not be overcome or cured with disclosure of trading practices that include trading ahead of the customer's order. The terms and conditions under which institutional account or appropriately sized customer limit orders are accepted must be made clear to customers at the time the order is accepted by the firm so that trading ahead in the firm's market making capacity does not occur. For purposes of this interpretation, a member that controls or is controlled by another member shall be considered a single entity so that if a customer's limit order is accepted by one affiliate and forwarded to another affiliate for execution, the firms are considered a single entity and the market mak-

ing unit may not trade ahead of that customer's limit order.

The Association also wishes to emphasize that all members accepting customer limit orders owe those customers duties of "best execution" regardless of whether the orders are executed through the member's market making capacity or sent to another member for execution. As set out above, the Best Execution Rule requires members to use reasonable diligence to ascertain the best inter-dealer market for the security and buy or sell in such a market so that the price to the customer is as favorable as possible under prevailing market conditions. The Association emphasizes that order entry firms should continue to routinely monitor the handling of their customers' limit orders regarding the quality of the execution received.

(b) Exclusion for Limit Orders that are Marketable at Time of Receipt

The Association has previously recognized the functional equivalency of marketable limit orders and market orders. Accordingly, it has adopted the following interpretation. IM-2110-2 shall not apply to a customer limit order if the limit order is marketable at the time it is received by a market maker. These orders shall be treated as market orders for purposes of determining execution priority; however, these orders must continue to be executed at their limit price or better.

The exclusion for marketable customer limit orders from the general application of IM-2110-2 is limited solely to customer limit orders that are marketable when received by a market maker. If a customer limit order is not marketable when received by a market maker, the

limit order must be accorded the full protections of IM-2110-2. In addition, if the limit order was marketable when received and then becomes non-marketable, once the limit order becomes non-marketable it must be accorded the full protections of IM-2110-2.

The following scenario illustrates the application of the exclusion. The market in XYZ stock is 25 bid-25 1/6 ask, the volume of trading in XYZ stock is extremely active, and Market Maker A ("MMA") has a queue of market orders to buy and sell. Assume the following order receipt scenario. Each sell market order in the queue is for 1,000 shares and there are no special conditions attached to the orders. MMA then receives a customer limit order to sell 1,000 shares at 25. The customer limit order is marketable at the time it is received by MMA. MMA hits another market maker's bid at 25 for 1,000 shares. Normally, IM-2110-2 would require that the customer limit order be executed before the market orders in the queue. However, because the marketable limit order and the market orders should be treated as functionally equivalent in determining execution priority, the marketable customer limit order shall not be given execution priority over the market orders that were already in queue. When the limit order is executed, however, it must be executed at the limit price or better.

In addition, if in the scenario just described the limit order does not get executed and the inside market in XYZ becomes 24 7/16 bid, the market maker would have to protect the limit order as required by IM-2110-2 if the market maker trades at the limit order price or better.